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## Other Post-Employment Benefits (OPEB)

### *New Accounting Requirements to Shed Light on Cost of State and Local Retiree Health Benefits; Funding Pressures Expected to Vary Widely*

#### Summary

Just as U.S. local and state governments are emerging from one of the most difficult fiscal periods in recent memory, they face a new hurdle in the form of accrued retiree health-care liabilities. The costs associated with retiree health benefits, though they have been magnified by growth in healthcare spending, are not a new phenomenon. Governments in coming years will have to improve their measurement and disclosure of OPEB costs and liabilities under statements 43 and 45 of the Government Accounting Standards Board (GASB). For many state and local governments rated by Moody's, the rules will apply to fiscal years starting after Dec.15, 2006. A wide range of previously unmeasured liabilities will be reported as a consequence, and the expected drive to address these liabilities will add to the fiscal pressures governments already face from programs such as public education, Medicaid, and employee pension funding.

Moody's does not anticipate that the liability disclosures will cause immediate rating adjustments on a broad scale. In fact, certain positive long-term effects seem likely to stem from the new requirements. This special comment describes the GASB statements and how they may affect the state and local government credit rating process. For municipal issuers, the credit impact of the new statements probably will depend on the following factors:

- The absolute size of unfunded actuarial accrued liability (UAAL) and UAAL size relative to key financial measures such as size of payroll, budget and tax base
- The plan for UAAL amortization as well as ongoing funding of new OPEB costs as incurred, on an accrual basis
- Actuarial assumptions, including discount and medical cost inflation rates, used to determine values of liability and pledged assets
- Retirement benefits promised to current workers and retirees as well as the ability (under contract or statute) to modify benefit offerings
- The impact of full funding on the issuer's financial flexibility and strength, based on measures such as debt or reserve levels
- The current credit assessment of the issuer and other factors affecting financial flexibility



## NEW RULES ARE INTENDED TO IMPROVE DISCLOSURE OF PUBLIC PAYROLL COSTS

Statements 43 and 45 will improve disclosure of costs that, along with salaries, pension benefits and pre-retirement health insurance, make up government employees' total compensation package. Like pensions, OPEB are a form of deferred pay, part of an exchange of salaries and benefits for employees' service. Their costs to employers accrue over the period of employment, even though the benefits are not provided until later. GASB's new standards require governments to measure and report OPEB costs as they are incurred, during the employment period. This mandate will force significant changes in government practice. Most governments, by measuring as expense only the outlays associated with current retirees' OPEB, have failed to capture the accrued cost and liabilities of promising retirement benefits to active workers. The actuarial methods used to estimate the cost of OPEB will be similar to those already applied to pensions. Biennial actuarial valuations of OPEB assets and liabilities will be required under the new accounting rules for state and local governments with 200 or more benefit plan participants; smaller plans will have to conduct valuations every three years and in some cases may be able to use an alternative method not requiring use of an actuary.

## OBLIGATIONS COVERED BY THE STANDARDS CONSIST PRIMARILY OF HEALTH INSURANCE

OPEB refers to retirement benefits besides pensions and early-retirement incentive (or termination) payments. These include various health-related benefits, as well as disability, life and long-term care insurance provided outside of defined-benefit pension plans. The largest component will be health insurance for which the employer pays some or all of retirees' premiums. The magnitude of this obligation will reflect the increases in prescription drug and other medical costs that have accounted for much of the recent growth in Medicaid, the joint state-federal health program for the poor.

GASB's new standards also require the inclusion in OPEB liability calculations of any implicit rate subsidy provided to retirees whose coverage is derived from a pool serving current employees (*see box*). It is because of this subsidy that even those state and local governments that do not explicitly pay part of their retirees' premium costs will likely have OPEB liabilities.

### IMPLICIT RATE SUBSIDIES

A government's retirees in many cases are able to purchase health insurance at the same premium rate as current employees, based on the blending of premium rates that would apply to the two groups independently. The cost per participant of covering both groups together is higher than current-employee coverage would be on its own, and not as high as the cost per participant in a group consisting solely of retirees. Because of this arrangement, retirees with blended-rate health benefits are said to receive implicit rate subsidies. The new standards require measurement and reporting of the rate subsidy of retirees, even in situations where the retirees are required to pay 100% of their stated premiums.

The rules apply to state and local governments and to government-sponsored enterprises, as well as government-owned hospitals, universities, and utilities. Non-profit organizations are covered by standards issued by GASB's sister organization for the private sector, the Financial Accounting Standards Board (FASB). Statement 43 applies to financial reports prepared by health insurance or other OPEB plans, and 45 applies to the governments themselves.

## STANDARDS ARE PART OF BROADER EFFORT TO IMPROVE ACCOUNTING FOR PENSIONS AND RELATED COSTS

The new accounting standards are part of a long-running effort in which GASB and FASB have mandated more disclosure of pension and other retirement benefit costs. FASB's Statement No. 81, issued in 1984, outlined disclosure practices for post-retirement health care and life-insurance benefits; Statement No. 87, in 1985, did the same for pension costs. Further clarification of OPEB cost reporting procedure followed when FASB issued Statement No. 106, in 1990. The same year, GASB published Statement No. 12, providing for disclosure of OPEB-related data in notes to governments' financial statements. These disclosures generally were to include the covered year's OPEB expense; the groups receiving (and the eligibility requirements for) the benefits; the respective contribution requirements for beneficiaries and employers; the statutory, contractual or other basis for the benefits, and a description of funding policy (either pay-as-you-go or paying in advance of future costs). Statement No. 12, which was intended as an interim measure, did not require the calculation of an actuarial accrued liability (AAL) or the recognition of current employees' accrued benefits. GASB in 1994 issued Statement No. 25 and Statement No. 27 to clarify how governments should report pension costs. Also at that time, it released Statement No. 26, providing interim guidance on financial reporting practices for post-employment healthcare plans administered by defined-benefit pension plans.

## INCREASED BENEFIT PRE-FUNDING, OPEB-BOND ISSUANCE AMONG LIKELY GOVERNMENT RESPONSES

Under the new rules, a government will determine the annual required contribution (ARC) needed to amortize its actuarial liability (in no more than 30 years) and to cover the “normal cost” associated with services rendered by employees during the current year. The UAAL will appear in the notes to financial statements and in a required multi-year schedule of funding progress. But to the extent that a government in a given year fails to make the full ARC, that year's funding deficit will create (or add to) a liability called the net OPEB obligation, which will appear in the statement of net assets. The rules require calculation of an annual OPEB cost that differs from the ARC once this net obligation is recorded. This cost, which must be recognized as an expense in accrual-basis financial statements, will be derived from the ARC plus interest on the net OPEB obligation.

Because failure to pre-fund benefits will result in new balance-sheet liabilities, governments may begin to set aside assets for future OPEB obligations to an increasing extent. Moreover, the rules allow a higher assumed discount rate (and hence a lower present-value actuarial liability) for plans with assets set aside in a trust for OPEB obligations than for those with no (or insufficient) assets set aside. Governments may seek to address large, unfunded liabilities for retiree healthcare through the issuance of taxable bonds similar to pension-obligation bonds. An early example of this practice is the city of Gainesville, Florida, which has issued bonds to address a \$30.6 million liability in its self-insured Retiree Health Care Plan. The credit impact of borrowing to address a retiree health plan funding deficit will depend, as it does with pension-obligation bonds, on the extent to which the debt is part of a realistic plan to address these liabilities, and on its effect on the issuer's overall debt burden.

## GOVERNMENTS HAVE BEGUN TO ADDRESS OPEB COST GROWTH

Some state governments, partly in response to the new standards, have already taken steps to reduce growth rates of their OPEB costs. Moody's expects this trend will continue, in part because improved OPEB information will encourage restraint in legislative debates and contract talks where benefits are determined. Alabama (rated Aa3 on watch for a possible upgrade) has enacted legislation increasing the premium payment obligation for various types of employees, including smokers and those who retire after a relatively short period of service. Ohio (Aa1) has modified its retiree health plan so that full coverage is available only to the employees with at least 30 years of service (*see box*).

### OHIO'S APPROACH TO POST-EMPLOYMENT BENEFITS

Ohio is one of the few states that already have accumulated assets pledged to retiree health obligations. The Ohio Public Employees Retirement System (OPERS) oversees an \$11 billion healthcare fund. Even so, because of rapid growth in both medical costs and the number of covered retirees, the OPERS trustees determined in 2003 that the health benefits fund would be used up in less than a dozen years. In September 2004, the trustees acted to restrain the fund's cost growth. They cut the portion of insurance premium coverage available to retirees with only 10 years of service to 50% for workers hired in 2002 or earlier, and to 25% for those hired later. For workers who retire with 30 years of service, however, 100% coverage was retained. The overhaul also reduced retiree spouse coverage and mandated increased contributions from active workers and employers. These actions are expected to extend the solvency of the health benefits fund to 18 years. Annual benefits and program adjustments will be reviewed periodically to maintain a balance between responsibilities of the system and its members.

Utah (Aaa) passed legislation this session to change its practice of providing retirees a month of health insurance for every day of unused sick leave. This policy, which was initiated when health insurance costs were substantially lower, will be modified so that the wages for each day of unused sick leave are placed in retiree health savings accounts, which retirees will then be able to use to purchase their own health coverage. The state still will have to address the liability accumulated through its existing policy, which remains in effect through the end of calendar year 2005. Other states that have taken steps to prepare for compliance with the new OPEB accounting rules include Delaware (rated Aaa), which in May of this year formed a committee to oversee an actuarial assessment of retiree health liabilities. In 2003, Delaware performed an actuarial analysis of its retiree health benefits using a preliminary version of the GASB standard. Georgia (rated Aaa), also in May, enacted a law creating the Georgia Retiree Health Benefit Fund to receive annual contributions based on the state's ARC.

Local governments also have begun to scale back retirement health-benefit offerings for new employees. After performing actuarial assessments of liabilities, Orlando, Florida (Aa2), and Arlington, Texas (Aa2), modified the percentages of employees' healthcare premiums that are covered, as well as length-of-service requirements for eligibility.

## RETIREMENT HEALTH BENEFITS VARY WIDELY AMONG STATES AND LOCAL GOVERNMENTS

Retiree health benefits offered to public employees vary dramatically among state and local jurisdictions. States such as Iowa (Aa1) and Mississippi (Aa3) offer little or no health-care coverage to retired workers. Some, such as Wisconsin (Aa3) and Montana (Aa3), offer post-employment health insurance but require retirees to pay most of the cost. Still other states, such as California (A3), fully cover many retirees' health-insurance premiums as well as the majority of the premium costs for retirees' dependents. New Jersey covers retiree health insurance costs of local school teachers and college and university professors in addition to those of its regular employees. As a result, its OPEB expenditures for existing retirees already account for more than 3% of its general fund budget. A Kaiser Family Foundation survey of state governments found that in 2002, monthly premiums ranged from as little as \$105 per month for the Indiana (Aa1) Medicare complement plan to as much as \$668 per month in an indemnity-style plan provided by Alaska (Aa2).<sup>1</sup>

State and local governments are further distinguished by benefit eligibility requirements, the legal measures that provide for the benefits, and the demographic characteristics of covered employee and retiree groups. As a result, there is likely to be great variation in the relative sizes of OPEB liabilities reported.

## OPEB FUNDING STATUS WILL BECOME A MORE VISIBLE FACTOR IN CREDIT RATING PROCESS, SIMILAR TO PENSION OBLIGATIONS

As governments and their retirement benefit plans begin issuing financial reports in compliance with the new rules, OPEB funding status will become more visible among the many attributes Moody's assesses in the municipal credit rating process. While it will most closely resemble pension funding status, there are differences between the two types of obligations. OPEB obligations reflect medical cost trends, while those for pensions are based on salaries, over which a government's management has more control. On the other hand, retiree health benefits may be somewhat easier to modify than pensions, which may have stronger legal or contractual protection. Moody's views both OPEB and pension obligations as less binding than bonded debt, because they tend to allow some flexibility to alter the terms of the benefits (such as eligibility requirements), the assumptions used to derive the actuarial values of plan assets and liabilities, the liability amortization schedule, or other variables.

Moody's therefore will exclude OPEB liabilities from calculations of state or local debt burdens, but include them as a factor in the overall credit assessment of an issuer. This practice is consistent with Moody's approach to municipal pension liabilities. Some governments provide post-retirement health benefits through pooled programs known as cost-sharing, multiple-employer plans. For these governments, the new standards will require reporting of OPEB payments in relation to the amount contractually mandated by their cost-sharing plans. Moody's may have to rely in these cases on the financial reports of the plans, rather than of the governments participating in them, for actuarial information on OPEB funding.

## IMPORTANCE OF OPEB TO RATING PROCESS WILL DEPEND ON ISSUER'S OVERALL CREDIT STANDING

The extent to which OPEB funded status becomes an influential or decisive credit factor will depend on an issuer's current rating and how consistent its other attributes are with that rating. State and local governments' liabilities may be large in many cases, given the lack of prefunding in the past. For some issuers, it is possible that efforts to satisfy OPEB funding requirements will exacerbate fiscal pressure. Even so, Moody's does not anticipate that the disclosures required by the new rules will cause immediate and widespread rating adjustments. It is more likely that rating levels will be affected by observations of changes in OPEB funding measurements over time. Statistics such as the UAAL-to-covered payroll will be made available under the new rules, and Moody's expects to use these in the rating process. Plans for UAAL amortization, amortization periods, use of debt, and differences between actual and required contributions will also figure into the analysis, along with actuarial assumptions about medical costs and other variables key to estimating OPEB liabilities. Issuers' flexibility under relevant statutes or contracts to modify their post-employment health benefit offerings will likely be another focal point. Moody's also will monitor financial reserve, liquidity and debt levels that will be affected as issuers begin to set aside funds for OPEB. In general, a state or local government's effectiveness and initiative in OPEB liability management probably will influence our overall assessment of the government's management strength.

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1. Hoadley, Jack: "How States are Responding to the Challenge of Financing Health Care for Retirees"; The Henry J. Kaiser Family Foundation, September 2003.

## LONGER-TERM IMPACT OF REPORTING REQUIREMENTS WILL BE LARGELY POSITIVE

Even though compliance with the new accounting rules is expected to exert financial stress and to bring to light previously unknown liabilities, Moody's expects the disclosure effects will be largely positive over the long term. As previously mentioned, the rules will require governments to disclose and record the full current cost of benefits provided to employees. Governments will have a strong incentive, though not an obligation, to set aside funds for benefit obligations as they are incurred, which is in keeping not only with accounting principles but also with prudent financial management. Any resulting fiscal strain is likely to be more than offset in most cases by the positive implications of management practice improvements under the accounting rules.

Until the release of audited reports subject to the standards, the lack of actuarially derived OPEB liability information limits Moody's ability to make a more detailed assessment of how these future costs will affect state and local government credit. Expenditures on current retirees' healthcare costs are already incorporated in the rating process. GASB's schedule for compliance with the new OPEB reporting rules is staggered, with smaller-revenue governments afforded additional time (*see Appendix I*). For states, the first financial reporting periods subject to Statement No. 45 will be those ending during calendar year 2008. A comprehensive overview of states' OPEB funding status is therefore not likely until early 2009, when published comprehensive annual financial reports covering fiscal 2008 become available. At that time, Moody's will focus on the OPEB factors listed earlier, including the UAAL size relative to key financial indicators and the plan for UAAL amortization. Before compliant financial statements become available, Moody's may request information from issuers on various aspects of health plans and other retiree benefits that factor into OPEB liabilities (*see Appendix II*).

## Appendix I

Effective Dates	
<b>GASB 45</b>	
Government Description	Effective Date
Tier 1 (annual revenues > \$100 mln*)	Yrs Starting After 12/15/2006
Tier 2 (annual revenues > \$10 mln)	Yrs Starting After 12/15/2007
Tier 3 (annual revenues < \$10 mln) Yrs Starting After 12/15/2008	
<b>GASB 43</b>	
Plan Description	Effective Date
Tier 1 (annual revenues > \$100 mln)	Yrs Starting After 12/15/2005
Tier 2 (annual revenues > \$10 mln)	Yrs Starting After 12/15/2006
Tier 3 (annual revenues < \$10 mln) Yrs Starting After 12/15/2007	
* Tiers are based on first fiscal year ending after June 15, 1999, the same basis as applied to Statement No. 34.	

## Appendix II

### Following are examples of questions Moody's will pose pending disclosure under the new rules:

- 1) Has an actuarial assessment of OPEB liabilities been performed? If so, what were the accrued actuarial liability, actuarial value of plan assets, and funded ratio?
- 2) What health-care and other post-employment benefits subject to the standards are provided? What are the benefits' eligibility requirements?
- 3) Describe the mechanisms (e.g., single-employer or agent multiple-employer defined- benefit plans) through which benefits are provided.
- 4) What legislative or other actions would be required to reduce the benefits' cost?
- 5) What is the total cost of retiree health and related benefits in the budget? How much has this sum changed in recent years, and what has accounted for that?

## Related Research

### **Special Comments:**

[GASB 34: What Does It Mean for the Rating Process?, December 2002 \(#76862\)](#)

[Moody's Perspective On Increased Pension Costs For California Local Governments, June 2003 \(#78417\)](#)

### **Rating Methodology:**

[Moody's State Rating Methodology, November 2004 \(#89335\)](#)

*To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.*



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